Section: Ask S&B
Date Written: 10/22/10
NPC ID#: 48349
Contact: Brad Stark, 805-690-3901, bstark@missionwealth.com

Title: Scared of Inflation?

Dear S&B: What is this debt deflation cycle and it's relation to housing? – Frank, Santa Barbara

When societies take on too much debt, it can lead to economic circumstances such as those we are experiencing today. In response, humans do a very natural thing by redirecting cash flow toward paying down debts and increasing savings. While that is fiscally sound, it takes money out of the "system" normally spent on goods and services. The result can be a sluggish economy with downward pressures on inflation. With that said, does the state of the housing market extend the "normal" recovery further out than normal?

From our seat the answer is, no. But we think the poor conditions of the real estate market, especially housing, will have the biggest impact on keeping interest rates and inflation low. To put it another way, when you have high unemployment and a large overhang of unsold homes with a growing inventory of foreclosures, supply simply outweighs demand.

How do you stop falling prices? You have to create demand and that is simply a factor of economic growth and available money for people to make purchases. The Federal Reserve is anticipated in the coming weeks to announce another round of quantitative easing. In layman terms, printing money. Doesn't that cause inflation? That is what they are hoping for along with some economic growth.

So many people are afraid of inflation but they should be more concerned with deflation (a destroyer of wealth). Unless you really need something right this minute and you see the price falling, you do the natural thing and wait. If enough people do the same thing, prices continue to drop. While you love this set of circumstances as a consumer, it destroys profits and ultimately the capital of the sellers.

While some people will say, "who cares it's their risk," you have to think about the bigger collective "us." This world is interdependent on goods and services being produced and consumed. Falling prices leads to lower profits which often times results in higher unemployment. It's pretty much that simple.

Not unlike previous recessions, businesses laid off people to protect profits (some would say for their greedy purposes). While that may be true, in order to run a business they often times do so on debt either through bond raises or through lines of credit issued by banks.

In order to maintain those lines necessary to run the business, they need to maintain certain ratios and satisfy financial "covenants" in order to keep their bond ratings or bank loans in good standing. Without that capital, the company can drop into receivership or not be able to expand operations (i.e. hire people). Or they can become non-competitive and then what good happens for their employees?

So when you boil it all down, we can get caught up in a "catch 22" where if you layoff too many people, the economy becomes so damaged that continued layoffs occur (i.e. depressions). The government and the Federal Reserve are trying to create inflation and stimulate economic activity. The idea is that once prices start to appreciate and businesses grow (hire people), the economic ball should change direction. Hope for inflation…the alternative is beyond dreadful.

If you have a questions you would like answered, please submit them to asksb@missionwealth.com.

Author's Note: Brad Stark, MS, CFP, AAMS, CMFC and Seth Streeter, MS, CFP, CEA, Co-Founders of Mission Wealth Management, LLC, a Registered Investment Advisor. The information contained in this article is general in nature and should not be construed as comprehensive financial, tax, or legal advice. As with any financial or legal matter, consult your qualified securities, tax, or legal representative before taking action. Securities offered through National Planning Corporation, Member FINRA/SIPC. NPC and MWM are separate and unrelated entities. Certain statements contained within may be forward-looking statements, including but not limited to, statements that are predictions of or indicate future events, trends, plans or objectives. Undue reliance should not be placed on such statements because, by their nature, they are subject to known and unknown risks and uncertainties. All statements subject to change without notice.